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IN THE

Supreme Court of the United States

OCTOBER TERM 1957

No. 97

UNITED STATES OF AMERICA,
PETITIONER

VS.

R. F. BALL CONSTRUCTION COMPANY, INC.,
and UNITED PACIFIC INSURANCE COMPANY,
RESPONDENTS

Brief For Respondent, United Pacific Insurance Company

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PRELIMINARY STATEMENT

In a nutshell, the principal question in this case is whether or not prior contract rights may be destroyed by a subsequently filed federal tax lien. Petitioner would have this court overrule its own prior decisions on this question and have this court legislate on matters which Congress has not only failed to legislate upon but has expressly refused to so legislate. A brief, chronological statement of the facts in order to specifically bring before this court the true question involved would seem to be in order.

On July 17, 1951, Ball, a general contractor on a housing project in San Antonio, subcontracted the painting portion of the work to Jacobs and required of him a faithful performance bond. (R.1)

On July 21st, Jacobs applied to respondent surety company for a bond payable to Ball, which was executed by respondent on July 23, 1951. (R.4)

To secure the surety against loss, Jacobs assigned, transferred and conveyed to it "as collateral security for the full performance of the covenants and agreements herein contained and the payment of any other indebtedness or liability of the undersigned to the Company, whether heretofore or hereafter incurred * * * all right, title and interest of the undersigned in and to all percentages retained by the obligee under said contract * * *". (R.5) The retained percentages under this San Antonio contract constitute the basis for this litigation.

Some nine months later, and at a time when Ball had in its hands such of the retained percentages as had been earned up to that time and which had been previously assigned by Jacobs to respondent, Jacobs applied to the respondent for another bond on a contract in Kentucky, which bond was executed by respondent. As part of the consideration for the execution of this bond on April 4 1952, Jacobs agreed to indemnify respondent against all loss, and respondent at that time had the assignment of the retained percentages on the San Antonio housing job as security against loss on the Kentucky job (R.5, 6). Furthermore, at the time the respondent incurred its liability on the Kentucky job, not only had no tax liens been filed, but none of the taxes which are the basis of the petitioner's claim herein were even due. (R.3)

It was stipulated that on April 30, 1953, the Housing Authority in San Antonio accepted the work of Ball, which clearly shows that all work, including the work of Jacobs, was completed, and it was also stipulated that as of April

30, 1953, Ball was indebted to Jacobs in the sum of $13,228.55, as being the retained percentages under this housing contract. (R.2)

Thereafter, notices of tax liens were filed on May 19, 1953, June 9, 1953, and September 5, 1953. (R.3)

There is no stipulation and no evidence in this record as to when Jacobs actually defaulted on the Kentucky job, but between December 1953 and March 1954, respondent surety company "by virtue of its obligation under" the bond which was executed more than a year prior to the filing of any tax liens, and ostensibly with knowledge of the fact that it had as security the retained percentages under the San Antonio housing contract, was required to pay on the Kentucky contract the sum of $12,971.88. (R.6)

While Ball still had in his hands the retained percentages under the housing contract, both petitioner and respondent, along with others no longer of importance, presented claims thereto, so Ball, in order to protect himself, filed this suit in the nature of a bill of interpleader.

BY VIRTUE OF ITS PRIOR ASSIGNMENT THE SURETY BECAME EITHER A "MORTGAGEE, PLEDGEE (OR) PURCHASER" WITHIN THE MEANING OF SEC. 3672 OF THE INTERNAL REVENUE CODE OF 1939.

The assignment in question took place approximately two years prior to the filing of the notice of the Government's tax liens and before the filing of any such notices the amount available as security became fixed and definite in the sum of $13,228.55. Likewise, more than a year before the notice of the Government's tax liens was filed, the surety, ostensibly on the strength of its security, incurred an additional liability on behalf of Jacobs, which obliga-

tion it was later required to discharge in the amount of $12,971.88.

At the time the surety incurred this additional obligation, it had no information that any taxes were due petitioner, and in fact none of the taxes which are the subject matter of this suit were even due at the time the surety entered into its obligation. (R.3)

The courts below, in following all of the decisions up to this time, held that respondent, by virtue of its assignment, attained the status of a mortgagee, pledgee, or purchaser of these retained percentages and as such was protected as against the subsequently filed notices of tax liens under the provisions of section 3672 of the Internal Revenue Code of 1939, now section 6232 of the Internal Revenue Code of 1954, Title 26, U.S.C., which provides in effect that no federal tax lien shall be valid against "any mortgagee, pledgee (or) purchaser" which is prior in time to the filing of notice of such lien. In this holding, we submit that the courts below were correct.

The opinion below speaks eloquently for itself and we will not burden this court with repetition of the arguments and authorities cited therein. There are, however, additional aspects which we desire to bring to the attention of this court.

THE TEXAS LAW WHICH CREATED THE SURETY'S INTEREST PREVAILS

It will be noted that the courts below gave preferred status to the surety as being either a mortgagee, pledgee or purchaser under the Texas law. A subsequent decision confirms the fact that Texas law is controlling on the question of the existence of the surety's interest created by this

assignment. We refer to the case of *Fidelity and Deposit Company vs. N.Y. City Housing Authority*, 241 F.2d 142 (C.A. 2 1957), where the court, in relying upon this court's decision in *Morgan v. Commissioner*, 309 U.S. 78, 80, stated:

> "Section 3670 imposes a tax lien on 'all property and rights to property' of a defaulting taxpayer. In adopting this legislation, the Congress did not create property interests on which a lien might be imposed; there is no suggestion that it authorized the federal courts to do so. On the contrary, it took for granted here, as it normally does in the tax law the vital existence of state laws creating and maintaining various interests. The statute was fashioned to require the courts to determine for federal purposes whether those state-created interests are 'property' or 'rights to property'. That classification of interests is a federal question; the existence of the interests to be federally classified, however, is solely a question of state law.'
>
> "This distinction was formulated by the Supreme Court in Morgan v. Commissioner, 309 U.S. 78, 80, 60 S. Ct. 424, 426, 84 L.Ed. 585, which also involved the tax law. 'State law,' the court explained, 'creates legal interests and rights. The federal revenue acts designate what interests or rights, so created, shall be taxed'."

That this assignment is valid under the Texas law was squarely decided in the case of *Southern Surety Company v. Bering Mfg. Company*, 295 S.W. 337 at 341 where the Texas court said:

> "When Ness as part of the consideration for the execution of the surety bond by the appellant surety company, 'conveyed and assigned unto the said company', as security for indebtedness then due by him to the company and any subsequent indebtedness

> which he might incur to it, 'any and all payments, funds, moneys, and property due, or to become due,' to him under his building contract with the press company, he thereby assigned the fund in question in this case. The validity of the assignment is in no way affected by the fact that there was no fund in actual existence at the time it was made."

The "other indebtedness" clause in this assignment is valid and is a perfectly legitimate contractual business transaction. See *Bridgeton National Bank v. Commercial Cas. Co.*, 180 Atl. 832 (N.J. 1935); *Lacy v. Maryland Cas. Co.*, 32 F.2d 48 (CCA 4, 1929); *Wike v. Board of Trustees*, 49 S.E.2d 740 (N.C. 1948). See also the de facto assignment contained in the 11th section of the bank's charter involved in *Brent v. The Bank of Washington*, 35 U.S. 596, 598. The validity and effect of an assignment of a chose in action "as collateral security" has been recognized by this court in *Conard v. Atlantic Insurance Co.*, 26 U.S. 296, and *Harrison vs. Sterry, 9 U.S.* 286. See also the statement of the Conard case, supra, in *Brent v. The Bank of Washington*, 35 U.S. 596, 612.

The classification of state-created rights in determining what interests are protected under Section 3672, is a matter that involves the intent of Congress. In addition to the discussion of this matter of classification in the opinion of the courts below, we call attention to the enlightening discussion in the unpublished opinion of the trial court in *U.S. v. Gargill*, 218 F.2d 556, wherein the trial court in construing section 3672, said:

> "It seems to me plain that it was the intention of Congress that a mortgage or pledge of any sort should be given priority over an unrecorded tax lien. It makes no difference whether the mortgage

> corresponds to the ancient English form or some other form. It makes no difference whether it is to secure antecedent debt or newly acquired debt. It makes no difference whether the mortgagee is left in possession or not left in possession. The only thing which is required is that the transaction be such that the person or persons claiming to have the mortgage shall have that kind of security which involves either a transfer of title or a lien which is of a nature that gives the holder a right in rem with respect to the property and privilege to precede unsecured creditors. The phrases used in the statute were not used with some medieval notion of mortgage, pledge, or the like. The whole object of the Congressional legislation is not to resurrect a page of Year Book history but to give that protection which persons in a modern world associate with the security that they have achieved as a result of their diligence and forethought."

Surely, the surety in this case obtained by the assignment "that kind of a security which involves either a transfer or title or a lien which is of a nature that gives the holder a right in rem with respect to the property and a privilege to precede unsecured creditors."

As was stated by the courts below:

> "It is the Congress which enacts the law with reference to priorities and not the courts."

And it is the function of this court to determine what Congress had in mind when it used the terms "any mortgagee, pledgee (or) purchaser", in section 3672 of the Internal Revenue Code.

Congress has itself spelled out its intention in connection with the meaning of these words. In 1954 Congress

was in the process of completely revamping the Internal Revenue Code and it had before it the question of whether or not section 3672 of the 1939 Code should be amended. Appendix A of this brief is the complete report of the Committee on Ways and Means in the House of Representatives, and Appendix B hereto is the report of the Committee on Finance of the U. S. Senate having to do solely with amending 3672. It will be noted that in the House report it was suggested that just who is "any mortgagee, pledgee (or) purchaser" should be spelled out, and in explanation of this suggestion the committee report says:

> "This subsection is not designed to extend the protection of subsection (a) of this section to categories of persons now denied protection by existing court decisions (under Section 3672[a] of the 1939 code) which determine who is a mortgagee, pledgee, purchaser, or judgment creditor by reference to the realities and the facts in a given case rather than to the technical form or terminology used to designate such person."

The Senate report rejected the House proposal as being unnecessary and with the subsequent concurrence of the House, Section 3672 was left intact because, as said by the Senate report:

> "Subsection (c) of the House bill provided certain rules with respect to the validity of the tax lien, without the filing of notice thereof, as against mortgagees, pledgees, purchasers, or judgment creditors. The applicable rules have been developed under existing law by judicial construction, and your committee deems it advisable to continue to rely upon judicial interpretation of existing law instead of attempting to prescribe specific statutory rules. The deletion of subsection (c) will continue in effect the existing law.

> "This section corresponds to section 3672 of the 1939 Code. As under existing law, a person who is in fact a mortgagee, pledgee, purchaser, or judgment creditor will be entitled as such to the protection of this section irrespective of the designation applied to such person under State law, for example, in a State which has adopted the Uniform Commercial Code and which uses other terms to describe such persons."

In other words, in 1954 Congress was satisfied with the then court decisions construing the term "any mortgagee, pledgee (or) purchaser" to the effect that regardless of the label placed on a contract lien creditor if he was "in fact a mortgagee, pledgee (or) purchaser" he would be protected and Congress was likewise satisfied with the existing court decisions which determined who is any mortgagee, pledgee (or) purchaser "by reference to the realities of the facts in a given case rather than the technical form or terminology used to designate such persons."

Even the Treasury Regulations themselves spell out this same thing, for Treasury Regulation 301.6323-1 reads as follows:

> "The determination whether a person is a mortgagee, pledgee, purchaser, or judgment creditor, entitled to the protection of section 6323(a), shall be made by reference to the realities and the facts in a given case rather than to the technical form or terminology used to designate such person. Thus, a person who is in fact and in law a mortgagee, pledgee, or purchaser will be entitled as such to the protection of section 6323(a) even though such person is otherwise designated under the law of a State such as the Uniform Commercial Code."

What were these decisions that Congress was satisfied with? They were the very decisions relied on and cited by

the lower courts in this case, such as *Knight v. Knight*, 71 N.Y.Supp. 2d 357, *National Refining Co. v. U.S.*, 160 F.2d 951, *U.S. v. Anders Contracting Co.*, 111 F.Supp. 700, *U.S. v. Gargill*, Supra, *Evans v. Stewart*, 66 NW2d 442 and many others to the same effect.

In its brief the Government argues against according a mortgage status to this assignment. Significantly, the Government verges on destroying its own argument when it recognizes indemnity mortgages in Note 13 of its brief.

THE SURETY WAS AN INDEMNITY MORTGAGEE

The surety, by virtue of the assignment as collateral security, which was executed some two years prior to the filing of any notices of tax liens, became in reality what is known in law as an indemnity mortgagee. Indemnity mortgages have been recognized not only in Texas, but by this court since an early date; an indemnity mortgage being one which is given to secure a surety on its contingent liability. More than 150 years ago, John Marshall, Chief Justice of the United States, in the case of *U.S. v. Hooie*, 3 Cranch 73, 2 L. Ed. 370, upheld an indemnity mortgage as against a claim of priority by the United States. There, one Hooie went surety on a bond for one Fitzgerald and took an indemnity mortgage as security. In a contest of priorities between the United States and the surety, Chief Justice Marshall said:

> "The deed is made to save Hooie harmless on account of his having become security of Fitzgerald to the United States * * *. All the covenants in the deed appear to the court to be fair, legitimate and consistent with common usage."

The court then went on to uphold the mortgage to secure this contingent liability of the surety.

Such was likewise the situation in the very early Texas case of *Williams v. Silliman*, 74 Tex. 626, 12 S.W. 534, where the Supreme Court of Texas upheld an indemnity mortgage to a surety in a very brief opinion, which closed with the statement:

> "The desire to indemnify his security against loss was a sufficient consideration for the execution of the mortgages."

41 Corpus Juris, 459 states as follows:

> "D. INDEMNITY MORTGAGES — 1. VALIDITY IN GENERAL. It is well settled that a mortgage given by way of indemnity, that is, not founded on a present debt, but meant to secure the mortgagee against loss or damage in consequence of a contingent liability or responsibility which he has assumed or agreed to assume for and on behalf of the mortgagor, as surety, bail, indorser, or otherwise, is valid and enforceable.
>
> "FUTURE LIABILITIES. An indemnity mortgage may be given to secure the mortgagee not only as against debts or liabilities for which he has already assumed responsibility or liability, but also to protect him against loss or damage on indorsements, suretyships, or other liabilities which he may in the future enter into for the benefit of mortgagor."

Many authorities from the various states are cited in support of these statements.

The same authority, on page 528, in discussing priorities of an indemnity mortgage, says:

> "A mortgage given to indemnify the mortgagee or to secure him against a secondary or contingent liability, such as that of an indorser or surety, may take precedence over liens created subsequent to its execution * * *"

On this same subject, 36 Am. Jur. 720, has the following to say:

> "A mortgage need not be founded on a present debt, but may be given to secure the performance of other obligations. The mortgage may be made to secure future advances or to indemnify against a contingency which may in fact never occur. It may be given to secure one as an indorser or as a surety upon a bond. The security of a mortgage given to indemnify sureties has been held not to be limited to the nominal money consideration recited, but to extend to the amount for which the sureties ultimately prove liable."

Similar statements are found in 59 C.J.S. 138 and 215.

It is therefore submitted that the surety in this instance was an indemnity mortgagee and when the Congress provided in effect that a federal tax lien would be subordinate to "any mortgagee" which was prior in time, the term "any" included indemnity mortgagees such as the surety in this instance.

THE SURETY COULD BE SAID TO BE PLEDGEE

In regard to a pledgee status, the Government argues that a pledge must be accompanied by a transfer of possession of the property, but the Government fails to point out that the pledgor in question here, namely Jacobs, never had possession. Actual possession was at all times in the prior pledgee who was Ball, the general contractor, and who was holding the retained percentages as security for the performance of Jacob's obligation.

In the case of *Gins v. Mouser Plumbing Supply Co.*, 148 F.2d 974 (CCA 2 1945). The question of the transfer of

possession of pledged property was discussed in a situation similar to that here, namely, where the pledgor is not in possession of the pledged funds or property but such pledged funds or property are in the hands of a prior pledgee. There the court stated:

> "Delivery to the pledgee is required primarily as notice to the pledgor's creditors and possible purchasers that the property in question is no longer free from prior interests of third parties. (citing authorities). But when the property is no longer in the pledgor's possession, ordinarily no good reason exists for requiring further delivery. And the courts have recognized this in holding or indicating with regard to numerous transactions that delivery to or possession by a third party is sufficient to perfect the lender's pledge interest. (citing many authorities)"

Furthermore in the case of *Town of River Junction vs. Maryland Casualty Co.*, 110 F.2d 278, 281 (C.A. 5 1940), cert.den. 310 U.S. 634, the court spoke of retained percentages "just as though the contractor had pledged so many liberty bonds."

As was said by the trial court, relying upon *Knight v. Knight*, supra,

> "It could be said, therefore, as was held in the Knight case, that the bonding company 'comes within the classification of pledgee."

THE SURETY COULD BE SAID TO BE A PURCHASER

The courts below likewise clearly implied that the surety in this case could come within the classification of a purchaser, relying upon *National Refining Co. v. U.S.*, supra. Since the decisions of the lower courts in this case,

the Court of Appeals for the Tenth Circuit has recently handed down its opinion in the case of *Marteney v. U.S.*, 245 F.2d 135.

In that case, Marteney had given his lawyers a note for certain legal services. Subsequently an assignment of interest in a suit that Marteney had against the United Press Association was made to the lawyers in lieu of the note in question. Prior to any final disposition of the suit against the United Press, the Government filed notices of tax liens and after the filing of such notices a judgment was entered in favor of Marteney against United Press for $7500.00, which amount, together with interest, was paid into court. There, as here, the Government contended that its tax lien was superior to the assignment. There the court said:

> "The United States contends that at the time of the agreement Marteney had only an inchoate right which was contingent upon obtaining a judgment, and not transferable. The law of Kansas is that a contingent right in property may be transferred. * * * It was the clear intention of the parties that the attorneys should own the judgment to the extent of the amount due on the note and when Marteney's claim later ripened into a judgment, the transaction was complete. When the judgment was entered, under the terms of the agreement, which Marteney did not repudiate, the attorneys became the owners of Marteney's share of that judgment, or the proceeds thereof, to the extent provided for in the agreement, and to say that they were not purchasers within the meaning of section 3672 would be a failure to acknowledge realities. It would sustain the validity of a secret lien, contrary to the purpose of the statute."

Under the case of *Southern Surety Co. vs. Bering*, Supra, the law of Texas is no different from that of Kansas in that

a contingent right in property may be assigned. The decision in the Marteney case is now final, no appeal to this court having been taken, and, to paraphrase the decision in the Marteney case, "to say that the surety as assignee in this case was not a purchaser within the meaning of 3672, would be a failure to acknowledge realities," and the courts below were correct in indicating that the status of the surety could be classified as that of a purchaser.

THE FACT THAT THE DEBT TO THE SURETY WAS CONTINGENT IS IMMATERIAL

This court, at a very early date, recognized the validity of assignments to secure contingent debts. As heretofore stated, the case of *U.S. v. Hooie*, supra, by this court, upheld the validity of an indemnity mortgage where the debt to be secured was purely contingent. The *Hooie* case is greatly reinforced by the case of *Conard v. Atlantic Insurance Co.*, 26 U.S. 386. In the *Conard* case there was involved a respondentia loan, and in the note appended to the report of that case, (26 U.S. 386) it was said:

> "A *respondentia* loan is a loan of money upon merchandise laden on board a ship, the repayment whereof is made to depend upon the safe arrival of the merchandise at the destined port."
>
> "As the lender sustains the hazard of the voyage, he receives upon its happy termination a greater price or premium for his money than the rate of interest allowed by law in ordinary cases. The premium paid on these occasions depends wholly on the contract of the parties."

In other words, the merchandise in the *Conard* case was assigned to the le der as security for his debt contingent

upon the safe arrival of the vessel. There this court, in classifying this assignment as a mortgage, said (26 U.S. 189 at 213):

> "It is true that in discussions in courts of equity the mortgage is sometimes called a lien for debt and so it certainly is, and something more. It is a transfer of the property itself as security for the debt. This must be admitted to be true at law."

The assignment in the *Conard* case was quite similar to the assignment of the retained percentages in the instant case (See 26 U.S. 446), and of this assignment as collateral security, this court said:

> "But here the transfer was as collateral security. It was therefore a mortgage of the goods and the returns."

There the Government made a similar contention to that made here, namely, that the debt was too contingent to be recognized as valid, but this court struck down such a contention in the following language: (See p. 448)

> "First, it is said that this debt upon a *respondentia* bond is of too contingent a nature to uphold a mortgage, as collateral security for the payment of it. We know of no principle or decision that justifies such a conclusion. Mortgages may as well be given to secure future advances and contingent debts, as those which already exist, and are certain and due. The only question that properly arises in such cases is, the *bona fides* of the transaction. Then, again, it is said that the papers here disclose a transaction fraudulent in its own nature. But we are of opinion that there is no necessary implication of law on the face of these papers, which stamps it fraudulent; for aught that appears, the agreement may have been

> entered into with the most sincere and scrupulous good faith, and whether fraudulent or not, in fact, was a question for the jury upon the whole evidence, which was properly left to their consideration; and they have, by their verdict, negatived the fraud."

So here, if "the only question that properly arises" in this case is "the bona fides of the transaction," there is no hint in the record before this court of any lack of bona fides on the part of either Jacobs or the surety. It was an ordinary business transaction, the like of which takes place every day and obviously the Government did not question in the lower courts the bona fides of the transaction and asked no finding of fact of the trial court relative thereto.

It is therefore submitted that the lower courts were correct in holding that by obtaining an assignment of the retained percentages in question as collateral security the surety in this case came within the protection of section 3672 of the Internal Revenue Code and was either a mortgagee, pledgee or purchaser.

AFTER THE ASSIGNMENT OF THE RETAINED PERCENTAGES TO THE SURETY JACOBS HAD NO PROPERTY OR RIGHTS TO PROPERTY IN SUCH PERCENTAGES SUBJECT TO A SUBSEQUENTLY FILED TAX LIEN.

We believe that in the foregoing section of this brief we have demonstrated that the surety in this instance was entitled to protection by virtue of Section 3672. We submit further, however, that even apart from Sec. 3672 a subsequent federal tax lien is ranked by an antecedent assignment of a chose in action. This court, in *U.S. v. City of New Britain*, 347 U.S. 81, reaffirmed the doctrine of "first in

time is first in right," and this court has held that such antecedent assignment of a chose in action is protected against the impact of the federal priority statute. 31 U.S.C. Sec. 191; *Harrison v. Sterry*, supra, *Conard v. Atlantic Ins. Co.*, supra; and see also *Brent v. The Bank of Washington*, supra. The reasoning in these cases in connection with the priority statute is equally applicable to the tax lien statute. Thus, in *Brent*, supra, in commenting on *Conard*, supra, the court said:

> "It was held in all these cases to amount to a transfer of the absolute right to the property * * *. Such transfer will be protected against the United States though not an out and out sale in the course of business, so as to divest the equitable as well as legal interest of the party."

This divestment of interest of the assignor is fundamental for it means that he has no property in this respect. No property in him necessarily means no property to which the Government's tax lien may attach. There are many cases applying this principle. Leading ones include *Bankers Title & Abstract Co. v. Ferber Co.*, 105 Atl. 2nd 408 (N.J. 1954); *Scott v. Zion Evangelical Lutheran Church*, 70 N.W.2d 326 (S.D. 1955); *Fidelity & Deposit Co. v. N.Y. City Housing Authority*, supra, *Colusa-Glenn Production Assn. v. Phoenix Ins. Co.*, 145 F.Supp. 844 (D.C.Cal. 1956); *Royal Indemnity Co. v. Board of Education*, 137 F.Supp. 890 (D.C., N.C. 1956); *Ala. etc. v. Lehman etc.*, 122 F.Supp. 314 (D.C. Ala. 1954); *U.S. v. Crosland Construction Co.*, 120 F.Supp. 792 (D.C.S.C. 1954); affd. 217 F.2d 275 (C.A. 4. 1954); *Seaboard Surety Co. v. U.S.*, 67 F. Supp. 969 (Ct.Claims 1946) cert. den. 330 U.S. 826, 1947; *U.S. v. Long Island Drug Co.*, 115 F.2d 983 (C.A. 2 1940); *National Iron Bank v. Manning*, 76 F.Supp. 541 (D.C.N.J. 1948).

The no-property concept under the federal tax lien statute has been recognized by this court in *U.S. v. Kaufman*, 267 U.S. 408. Furthermore, this court has recognized that after assignment there is no interest left in the assignor. *Salem Trust Co. v. Mfgrs. Finance Co.*, 264 U.S. 182. The traditional attitude of the courts toward protecting assignments of choses in action is no different today from what it was in the time of Blackstone, for in 2 Blackstone Commentaries, 422, that great commentator stated:

> "* * * and our courts of equity, considering that in a commercial country all personal property must necessarily lie in contract, will protect an assignment of a chose in action, as much as the law will that of a chose in possession."

It is respectfully submitted that the surety in this case is protected by its assignment of the retained percentages as collateral security against a subsequently filed tax lien and that the prior contract right of the surety may not be destroyed by a subsequently filed federal tax lien.

The position of the petitioner in this case is quite similar to that taken by it in the case of *Stewart v. Chinese Chamber of Commerce*, 168 F.2d 708, where petitioner likewise sought to apply property belonging to a non-taxpayer to the payment of taxes owed by a taxpayer. There the court said:

> "The revenue laws are a code or system in regulation of tax assessment and collection. They relate to taxpayers and not to non-taxpayers. The latter are without their scope. No procedure is prescribed for non-taxpayers and no attempt is made to annul any of their rights and remedies in due course of law. With that Congress does not assume to deal and they are neither of the subject nor of the object of the revenue laws.

> "The distinction between persons and things within the scope of the revenue laws and those without them, is vital * * * To the former only does section * * * apply * * * and the well-understood exigencies of government and its revenues and their collection do not serve to extend it to the latter. It is a shield for official action, not a sword for private aggression."

To permit petitioner in this case to take the surety's money to pay the tax liability of Jacobs would be using the revenue laws as "a sword for private aggression." As was said in the case of *Alabama, etc. v. Lehman, etc.*, supra:

> "The assignment in the application for the bond by the principal to the surety has priority over the claim of the United States for taxes which were not due to United States at the time of the assignment."

DISCUSSION OF PETITIONER'S BRIEF

As was pointed out by the courts below, the petitioner is seeking to have this court, as it sought to have the lower courts, judicially amend section 3672, and to change the wording thereof from "any mortgagee" to the words "actual mortgagee" (R. 14) or, as stated by the courts below:

> "The government is seeking to read into section 3672 provisions which Congress has not seen fit to insert therein and the government would have this court construe such section to read: 'such lien shall not be valid as against any mortgagee *whose mortgage is due at a certain time and in a certain amount and which mortgage has been duly recorded in accordance with law.*'
>
> "Had Congress seen fit to make such a requirement it could have done so but I decline to read these words into the statute."

The lower courts further said:

> "The government argues that if an attachment or other judicial lien is not sufficiently 'choate' or complete 'to defeat a subsequent tax lien' then a mortgage to secure future indebtedness should likewise be inferior to a subsequent tax lien. Congress has in fact stated in section 3672 that before an attaching or other similar statutory lienor could claim priority over the government his claim had to ripen into a final judgment. U.S. v. Security Trust etc. supra, U.S. vs. Acri, supra. No such qualification was placed by Congress on the contractual lien of a 'mortgagee.' It is the Congress which enacts the law with reference to priorities and not the courts * * *"

The gist of the Government's contention in this case as it was in the lower courts, is as stated by the lower courts as follows:

> "The Government cites and contends that the case of U.S. v. Security Trust & Savings Bank, 340 U.S. 47, 71 S.Ct. 111; U.S. v. Gilbert Associates, 345 U.S. 361, 73 S.Ct. 701; U.S. v. City of New Britain, 347 U.S. 81, 74 S.Ct. 367; U.S. v. Acri, 348 U.S. 211, 75 S.Ct. 239; U.S. v. Liverpool etc. Ins. Co., 348 U.S. 215, 75 S.Ct. 247; and U.S. v. Scovil, 348 U.S. 218, 75 S.Ct. 244, are in point and are controlling in this case, and says;
>
> > "* * * the principles of United States vs. Security Trust & Sav. Bank; United States v. New Britain; United States v. Scovil; United States v. Acri; and United States v. Liverpool & London Ins. Co. supra, must be applied. "

As was pointed out by the courts below, the decisions of this court in the *Security*, *New Britain*, *Scovil*, *Acri* and

Liverpool cases "dealt with inchoate judgment liens and none of those cases dealt with the contract right of a 'mortgagee', 'pledgee' or 'purchaser'. The latter three categories are all based upon a contract right of some sort, whereas the term 'judgment creditor' and the other liens dealt with in those cases, such as water rent liens, municipal tax liens and landlord's distress liens, arose by virtue of some statutory right, not specifically referred to in section 3672."

As was pointed out by the courts below, the Government made the same contention in the case of *Evans v. Stewart*, supra. In that case the Supreme Court of Iowa said:

> "The only argument the Government advances, that the contract lien is not specific, seems to be that the landlord's contract lien was no different from his statutory lien and under either the landlord had to make his lien specific by taking action to secure possession of the property before either lien would be specific. A short answer to this argument is we are not concerned with the landlord's statutory lien. His contract lien is, we feel, a chattel mortgage and it could hardly be contended that a chattel mortgagee would have to foreclose before he could displace the Government lien under the provisions of Section 3672 making the Government lien invalid as to a mortgagee."

As was further pointed out by the courts below, the distinction between rights created by contract and a statutory lien is made clear by comparing the case of *Evans v. Stewart* with the *Scovil* case, when the lower court said:

> "In the Scovil case, the Supreme Court held that prior to the time it ripened into a final judgment, an incompleted statutory, landlord's lien was inferior to a federal tax lien, since the holder thereof was neither a 'mortgagee', 'pledgee', 'purchaser' nor 'judgment creditor'. In the Evans case the court held

> that a written contract landlord's lien contained in the lease was superior to a federal tax lien because it was a 'mortgage' within 3672. The Government did not appeal the Evans case."

What the petitioner is seeking to do in this case flies directly into the teeth of Mr. Justice Jackson's opinion in the case of *U.S. v. Security Trust & Savings Bank.* There, Justice Jackson goes into the legislative history of Section 3672, and he points out that when this section was adopted in 1939 the Congress itself stated that its intention was to prevent federal tax liens from seriously interfering with "business transactions," which of course meant contract rights. For this court to do what petitioner urges would "seriously interfere with business transactions." Practically no mortgage today is "choate" in the sense that it is a thing complete. In the vast majority of mortgages, pledges or other contract rights, it cannot be determined at the time of the execution thereof how much of the mortgaged or pledged property or funds will have to be used for the payment of the secured debt. In most instances today the mortgagor pays off the debt secured by the mortgage and when this happens there is no need to resort to the pledged or mortgaged fund or property. In other pledges or mortgages the pledgor or mortgagor pays off part of the debt. Furthermore, in most instances, the pledgor or mortgagor has the privilege which it sometimes exercises by paying it in advance, thereby reducing the amount of interest. Furthermore, in most mortgages or pledges, attorneys fees upon default are provided for and, of course, at the time of the execution of the mortgage it cannot be ascertained whether or not attorneys fees will be added to the amount of the mortgaged debt nor how much interest will be due and payable ultimately out of the pledged or mortgaged fund

or property. Therefore, in one sense of the word practically no mortgage today is choate in the sense of being complete in all respects. The business transaction in this case was an open and above-board one and the type of transaction that takes place every day. The whole transaction was in good faith and not intended to defraud creditors, the government or otherwise, and for this court to say that a perfectly legitimate and recognized business transaction such as the one at bar can be disrupted and nullified by a subsequently filed tax lien would "seriously interfere with business transactions" which is the thing that Congress has avidly guarded against.

Shall this court now lay down a rule which would in effect make a mockery of the long accepted Anglo Saxon legal doctrine of freedom of contract and the sanctity of such? Shall it lay down a rule which subverts contract rights acquired prior to the perfection of a tax lien when Congress has specifically refused to do so? Are prior contract rights loaded with a time bomb which can be exploded in the Government's favor when it acquires subsequent tax lien rights? Is the entrepeneur in every prior transaction charged with a notice arising from the statute that rights acquired from a taxpayer can later be divested on behalf of the government? How could business exist under such a rule? "On what meat doth this, our Caesar, feed that he hath grown so great" that he can override long accepted rights and principles?

We feel it safe to say that this court will follow its own decision in the case of Morgan v. Commissioner, supra, wherein it said:

> "State law creates legal interests and rights. The federal revenue acts designate what interests or right, so created, shall be taxed."

The government in this case, however avoids citing decisions from the Texas courts where the right here in question was created. Instead, it cites text writers and goes all over the United States for authorities to support its contentions.

It is clear that under the Texas law as laid down by the Supreme Court in *Williams v. Silliman*, supra; the contract right of the surety in this case was the result of a perfectly legitimate transaction, and the equitable doctrine of relation back has nothing to do with this case.

On page 9 of the petitioner's brief the petitioner says:

> "The courts below concluded that the phrase (other indebtedness) encompassed the indebtedness which subsequently arose between the taxpayer and the bonding company in connection with the entirely independent Kentucky contract. The Government argued that such a construction is erroneous, particularly when considered in light of the fact that a separate bond indemnifying the bonding company was executed in connection with the Kentucky contract (R. 5, 16). See Belton v. Bank, 186 N.C. 614; Wright v. Voorhees, 131 Ia. 408"

For the Government now to state to this court what it argued in the courts below is entirely outside of the record and not only is it outside of the record but it is an incorrect statement as well. The gist of the petitioner's argument in the lower courts was as stated in the lower courts' opinion. The Iowa and North Carolina cases now cited were not submitted either to the trial court or to the Court of Appeals. Both of these cases go off on the intent of the contracting parties, and the trial court in this case was given no opportunity to make a finding of fact as to such intent or as to what was within the contemplation of the parties to the

assignment of the retained percentages as collateral security. If the Iowa law as set forth in *Wright vs. Voorhees*, cited by petitioner, had any bearing on this case at all, which it does not, the Iowa court called attention to its previous decision in *Hellyer v. Briggs*, 55 Ia. 185, 7 N.W. 490, and said with reference to that case:

> "The mortgage was given to secure a general liability of the mortgagee as surety for the mortgagor under a bond and was held to cover all the indebtedness of the mortgagor secured by such bond"

The *Hellyer* case is much more nearly in point here than is the *Wright* case.

On page 15 in footnote 12, the petitioner states:

> "As just pointed out in the text, the after-acquired property here did not come into existence until April 30, 1953. At that very moment, the taxpayer's right to the $13,228.53 became subject to the federal tax lien which had arisen on March 16, 1953."

With this statement we take issue. The subject matter of this lawsuit is the retained percentages under a construction contract that began shortly after July 21, 1951. These percentages were retained by Ball from his payments to Jacobs throughout the time that the construction was in progress and the retained percentages did not "come into existence" on April 30, 1953. They came into existence as the work progressed. It was on April 30th that the work was formally accepted. How long before April 30th Jacobs' work had been completed and all of the retained percentages earned, does not appear in this record. Obviously this time element was not thought to be of any consequence by the petitioner in the trial court; otherwise stipulations

would have been demanded in connection therewith. Furthermore, although, as against Jacobs, possibly March 16, 1953, might be an important date insofar as the attaching of the tax lien is concerned, but the date March 16, 1953, has no bearing whatsoever as to the surety under 3672.

In the same footnote, the petitioner said:

> "Moreover, even a mortgage of after-acquired property requires a debt (or other obligation) as the subject of the mortgage. Here the debt did not arise until the period between December 1953 and March 1954—long after the federal tax liens had been recorded."

With this statement we likewise take issue. The obligation of the surety in this case was incurred when it executed the Kentucky bond on April 4, 1952, a year before any tax liens arose. The terminology of the faithful performance bond on the Kentucky contract is not in this record. However, by going to any form book this court can see the usual terms of such a bond, which terms are as follows:

> "KNOW ALL MEN BY THESE PRESENTS:
>
> That We, as principal and as surety, are held and firmly bound unto as obligee in the sum of $35,59[illegible] (R. 5), for which sum we bind ourselves, our heirs, executors, administrators, successors and assigns, jointly and severally by these presents:
>
> The condition of the above obligation is that: whereas on the 4th day of April, 1952, the principal entered into a contract with the obligee for

> NOW, THEREFORE, if the principal shall faithfully perform said contract according to its terms, covenants and conditions, then this obligation shall be null and void; otherwise to remain in full force and effect."

It is obvious that under such terminology the surety in this instance obligated itself to the extent of nearly $36,000 on the Kentucky contract on April 4, 1952. This obligation was subject to being nullified only if the principal discharged his obligations, which he did not do. For the petitioner now to say that the debt did not arise for a year and a half after the faithful performance bond was executed is sheer sophistry.

Likewise on page 15 in footnote 13, the petitioner says:

> "Although as applied to indemnity mortgages, there is authority (see 1 Jones on Mortgages, supra, Section 467, and cases cited) holding that the lien of such a mortgage takes effect from the time of its execution and delivery (particularly where an obligation to incur future liabilities exists), such authority has no standing in cases involving federal tax liens for, as this Court has said, the doctrine of relation-back has no application in such cases. United States v. Security Tr. & Sav. Bk., 340 U.S. 47, 50."

This court has never made any such statement and has never held that an indemnity mortgagee does not come within the category of "any mortgagee" within the meaning of Section 3672. All that this court said in the *Security Trust* case was that state law which provided that the lien of an attaching creditor upon final judgment related back to the time of the attachment could not affect an intervening federal tax lien. That is a far cry from holding that an

indemnity mortgagee does not fall within the classification of "any mortgagee".

On page 18 of its brief, petitioner says:

> "Moreover, Section 3672 (a) affords no protection, we believe, to mortgages for future advances, but rather only mortgages securing existing debts."

Petitioner then cites regulations of the Internal Revenue Service as authority. There was no need to cite the treasury regulations on the subject of an "open-end" mortgage. The case of *U.S. v. Phillips*, 198 F.2d 634 is ample authority to the effect that where an open-end mortgagee voluntarily pays money to the taxpayer against whom tax liens have already been filed, the Government is prior, but, as pointed out by the courts below, the payment by the surety in this case after the tax liens had been filed was not a voluntary payment at all; it was the discharge of an obligation which it had incurred more than a year prior to the fixing of any tax liens at all.

The petitioner continually refers, particularly on pages 18 and 19, to the payments made by the surety under its contractual obligation as being "advances". Just why petitioner should use the word "advances" in describing the payments made by the surety on an obligation which it assumed long prior to the fixing of any tax liens, is not clear unless it is for the purpose of misleading this court.

Webster defines the word "advance"—"to furnish, as money or other value, before it is due in aid of an enterprise; to supply beforehand." Of course, the surety in this case did not advance any moneys at all. On April 4, 1952, it obligated itself to pay $35,591 and when its principal defaulted it made payment as it was required to do under

its obligation. There is nothing in this transaction at all that could be properly classified as "advances."

The above comments relative to petitioner's brief in this case are merely illustrative of the adroit semantics resorted to by petitioner in this case. Other portions of petitioner's brief fall in the same category, but to point each and all of these out would unduly prolong this brief. The petitioner in this case is seeking to extend to commercial transactions and rights based upon contracts the principle that this court has heretofore applied to mere statutory liens which had not ripened into judgment liens. As was said at the American Bar Association meeting in July of this year in New York by Mr. J. Harry Cross, Esq. of the Baltimore Bar (see Proceedings of the Section of Insurance etc. of the American Bar Association for 1957):

> "As discussed above, the Supreme Court has considered the effect of a federal tax lien upon the interests of others. However, in every instance since the 1950 line of decisions, the interests of others consisted of state statutory liens. There, the court seemed concerned with the proposition that the state cannot by statute impair the standing of federal liens without the consent of Congress. The Supreme Court, having granted the Government's petition for certiorari in the Ball case, will now, for the first time, be confronted with the interest of another consisting of an antecedent contractual right, arising as a part of the transaction by which the chose in action had inception.
>
> "The commercial world will await the outcome with extraordinary interest because the Government's position, if successful, might subordinate a widely used credit arrangement — an assignment of money due or to become due under an existing contract, as collateral security — such subordination being to a federal tax lien against the assignor, which tax

lien was not in existence when the assignment was made, but arose subsequently."

CONCLUSION

It is submitted that Congress has never intended that antecedent contractual rights should be divested by a subsequently filed federal tax lien and that the courts below were correct in so holding, and that therefore the judgment of the courts below should here be affirmed; otherwise this would be a case of "robbing Peter" not to pay Paul, but to pay Caesar.

Respectfully submitted,

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APPENDIX A

EXCERPT FROM REPORT OF THE COMMITTEE ON WAYS AND MEANS, HOUSE OF REPRESENTATIVES, TO ACCOMPANY H.R. 8300—HOUSE REPORT NO. 1337, DATED MARCH 9, 1954. 83rd CONGRESS. UNITED STATES GOVERNMENT PRINTING OFFICE. Page A406

Section 6323. **Validity against mortgagees, pledgees, purchasers, and judgment creditors**

This section corresponds to section 3672 of the 1939 code. Subsection (b) makes it clear that the notice of lien shall be valid, notwithstanding any law of the State or Territory regarding the form or content of a notice of lien, if the notice is in such form as would be valid if filed with the clerk of the United States district court pursuant to subsection (a) (2) of this section. The Treasury Department has consistently taken the position that section 3672 of the 1939 code and the corresponding provisions of prior law authorize the State or Territory only to designate the local office for the filing of the notice of the lien. Subsection (b) is designed to eliminate any question as to the validity of the lien as against mortgagees, pledgees, purchasers, and judgment creditors, where notice thereof is filed in the office designed by the law of the appropriate State or Territory, even though the notice does not comply with other requirements of the law of the State or Territory as to the form or content of the notice. For example, the omission from the notice of lien of a description of the property subject to the lien would not affect the validity thereof, even though the law of the State or Territory requires that the notice of lien contain a description of the property subject to the lien. Subsection (b) of this section is declaratory of

the existing procedure and in accordance with the long-continued practice of the Treasury Department.

Subsection (c) makes it clear that the protection of subsection (a) of this section is not extended to a mortgagee, pledgee, or purchaser who takes with notice or knowledge of the existence of the Federal lien; and that such protection is not extended to a judgment creditor who does not have a valid judgment obtained in a court of record and of competent jurisdiction or to a judgment creditor who does not have a lien which has been properly perfected under such a judgment. This subsection is not designed to extend the protection of subsection (a) of this section to categories of persons now denied protection by existing court decisions (under section 3672 (a) of the 1939 code) which determine who is a mortgagee, pledgee, purchaser, or judgment creditor by reference to the realities and the facts in a given case rather than to the technical form or terminology used to designate such person. Paragraph (1) of subsection (c) provides that the lien shall be valid, without the filing of notice thereof, as against any mortgagee, pledgee or purchaser, if such mortgagee, pledgee, or purchaser had notice of knowledge of the existence of the lien at the time the mortgage, pledge, or purchase, was made. A dual requirement is set forth in paragraphs (2) and (3) of this subsection which a judgment creditor must meet to be entitled to the protection of the notice provisions of subsection (a) of this section. One requirement is that the judgment creditor must have actually obtained a valid judgment in a court of record and of competent jurisdiction for the recovery of specifically designated property or for a certain sum of money; and the other requirement is that the judgment creditor, in the case of a valid judgment for the recovery of a certain sum of money, must have a perfected lien under such judgment on the property as to

which the claims of the contesting parties relate. Furthermore, subsection (c) makes clear that particular persons shall not be treated as judgment creditors because State or Federal law artificially provides or concedes such persons rights or privileges of judgment creditors, or even designates them as such, when they have not actually obtained a judgment in the conventional sense.

Subsection (d) of this section is in all material respects the same as existing law.

Subsection (e) of this section makes it clear that the Secretary may, after a notice of lien has been filed (and such notice discloses the amount of the outstanding liability as of the time of filing), disclose the extent to which the original obligation has been reduced by subsequent payments. This is necessary for the protection of persons dealing with property subject to the lien who have a legitimate interest in determining the amount of the outstanding obligation, as well as to aid reestablishment of the taxpayer's credit.

APPENDIX B

EXCERPT FROM REPORT OF THE COMMITTEE ON FINANCE, UNITED STATES SENATE, TO ACCOMPANY H.R. 8300—UNION CALENDAR NO. 1635, DATED JUNE 18, 1954. 83RD CONGRESS. REPORT NO. 1622, PRINTED IN THE U.S. GOVERNMENT PRINTING OFFICE,

Page 575

Section 6323. **Validity against mortgagees, pledgees, purchasers and judgment creditors**

This section corresponds to that of the House bill except

for the deletion of subsection (c) of the House bill and conforming changes incident to such deletion.

Subsection (c) of the House bill provided certain rules with respect to the validity of the tax lien, without the filing of notice thereof, as against mortgagees, pledgees, purchasers, or judgment creditors. The applicable rules have been developed under existing law by judicial construction, and your committee deems it advisable to continue to rely upon judicial interpretation of existing law instead of attempting to prescribe specific statutory rules. The deletion of subsection (c) will continue in effect the existing law.

This section corresponds to section 3672 of the 1939 Code. As under existing law, a person who is in fact a mortgagee, pledgee, purchaser, or judgment creditor will be entitled as such to the protection of this section irrespective of the designation applied to such person under State law, for example, in a State which has adopted the Uniform Commercial Code and which uses other terms to describe such persons.

Subsection (b) of this section makes it clear that the notice of lien shall be valid, notwithstanding any law of the State or Territory regarding the form or content of a notice of lien, if the notice is in such form as would be valid if filed with the clerk of the United States district court pursuant to subsection (a) (2) of this section. The Treasury Department has consistently taken the position that section 3672 of the 1939 Code and the corresponding provisions of prior law authorize the State or Territory only to designate the local office for the filing of the notice of the lien. Subsection (b) is designed to eliminate any question as to the validity of the lien as against mortgagees, pledgees, purchasers, and judgment creditors, where notice thereof is filed

in the office designated by the law of the appropriate State or Territory, even though the notice does not comply with other requirements of the law of the State or Territory as to the form or content of the notice. For example, the omission from the notice of lien of a description of the property subject to the lien would not affect the validity thereof, even though the law of the State or Territory requires that the notice of lien contain a description of the property subject to the lien. Subsection (b) of this section is declaratory of the existing procedure and in accordance with the long-continued practice of the Treasury Department.

Subsection (c) of this section as redesignated by your committee is in all material respects the same as existing law.

Subsection (d) of this section as redesignated by our committee makes it clear that the Secretary may, after a notice of lien has been filed (and such notice discloses the amount of the outstanding liability as of the time of filing), disclose the extent to which the original obligation has been reduced by subsequent payments. This is necessary for the protection of persons dealing with property subject to the lien who have a legitimate interest in determining the amount of the outstanding obligation, as well as to aid reestablishment of the taxpayer's credit.